RESEARCH HIGHLIGHTS

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CONSUMER SUPPORT AND PROTECTION IN MORTGAGE AND HOME EQUITY BASED BORROWING: THE U.S. EXPERIENCE AND CANADIAN COMPARISONS

Introduction

Predatory lending came to light in the U.S. after a 1998 Housing and Urban Development (HUD) study showed that borrowers in low-income neighbourhoods were far more likely than others to pay high costs and fees for mortgages.

In response, the Federal Reserve Board in 1999, convened a nine agency working group to strengthen the existing laws. The resulting Task Force released its report titled "Curbing Predatory Lending" in March 2000. The report defined predatory lending as:

"Engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of the borrower's lack of understanding about loan terms. These practices are often combined with loan terms that alone, or in combination, are abusive, or make the borrower more vulnerable to abusive practices."

This External Research Program project was designed to assess whether the surge in predatory lending practices in the U.S. is an indicator of what is to come in Canada, or a uniquely U.S. phenomenon occurring because of the particular institutional, regulatory, social, and market framework in the United States.

U.S. Experience

Predatory mortgage lending in the U.S. has been focused in the subprime market. Subprime lending refers to programs that target borrowers with weakened credit histories typically due to payment delinquencies, previous charge-offs, judgements or bankruptcies. These programs may also target borrowers with questionable repayment capacity evidenced by low credit scores, or high-debt burden ratios.

The following describes some of the main predatory practices identified in the Federal Reserve Board's Task Force report:

- <u>Loan flipping</u> – this involves repeated refinancing of a loan by a lender, with high fees and sometimes prepayment penalties each time so that the borrower's equity is "stripped".
- <u>Excessive fees</u> – some brokers in the subprime market have been charging up-front fees of 8 to 10 per cent of the loan and the adding of a whole range of separate fees for specific activities, e.g. fees for document preparation, underwriting etc., or the inclusion of unwanted extras without the full understanding of the borrower.

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- Outright fraud and abuse – this can involve deceptive sales practices, and misrepresenting costs. One study from California reported that nearly seven in ten respondents to their survey of subprime borrowers said that they "saw key loan terms suddenly change for the worse at closing".
- Lending without regard to the borrower's ability to pay – this abuse has been blamed for high foreclosure rates in the subprime market.
- Aggressive marketing – in a survey, homeowners reported that they have, in some cases for years, received weekly mailings from a lender and frequent unsolicited telephone calls urging them to set up appointments, offering free appraisals, etc.
- Other reported abuses include – kickbacks to mortgage brokers, falsifying loan applications, forging signatures, itemizing duplicate services and charging separately for them, requiring credit insurance with a lump sum premium paid up front, and excessive prepayment penalties.

Methodology

As a first step, the U.S. experience was examined, including the legislation and political responses. Source material included reports of government working groups and task forces, academic papers and reports in real estate journals, papers and reports prepared by community groups and lenders associations, and the websites of the various players.

The Canadian legislation was then examined. Although Canada does not have the proliferation of acts and regulatory bodies at the federal and provincial level which exist in the U.S., differences in the institutional and social framework that might impact the spread of predatory practices in Canada were considered. Options to protect the borrower were then explored.

A background paper drawing together the above elements, and a questionnaire soliciting views on the key issues and options was distributed to 43 selected respondents in lending, regulation, credit counselling, brokerage and real estate. Ten responses were received. In view of the limited response, the views expressed cannot be construed as representative, but do serve as examples of some of the views surrounding this issue held by the targeted audience.

Findings

The principal findings of the research are that, to date, there is no evidence to indicate that predatory mortgage lending practices are a problem in Canada.

There is also little evidence to indicate that such practices will become a problem in Canada in the future.

Future Considerations

Although there is currently no evidence of predatory mortgage lending practices, the research does speculate on several factors that may or may not influence the potential development of predatory lending practices in Canada in the future. These factors pre-suppose that the development of such practices in Canada would parallel that within the United States.

Factors that may increase the potential for predatory lending development in Canada

- Build up of home-equity-rich, income-poor homeowners – in the U.S., predatory lending has been found mainly in the home equity loan market. The aging of baby boomers in Canada may increase the number of home-equity rich homeowners who are income-poor as result of reaching the end of their employment years. This may create an attractive pool of potential home equity borrowers, some of whom may have difficulty in obtaining loans in the traditional market.
- Reduced employment security – there may be a higher incidence of home owning households being temporarily income poor after having been steadily employed. This may add to the market for home equity loans from those with uncertain prospects who could therefore be vulnerable to predatory lenders.
- Internet loan advertising – junk mail and internet "pop ups" provide a cheap way of reaching those who would like to access some of their home equity but have impaired credit records. Home equity loans and mortgage loans have become one of the most common junk mail offerings.

- Profitability of the sub-prime market – the Canadian subprime market may be attractive to U.S. lenders seeking expansion given the maturity of this market in the U.S..This may increase the risk of experiencing the problems experienced in the United States.
- Less powerful lobby/advocacy groups than in the U.S. to ring the alarm bell – in the U.S. powerful lobby/advocacy groups conducted a campaign to combat predatory lending. While Canada has its advocacy groups they do not have the resources of the massive U.S. groups to draw attention to the issue and lobby for action.

Factors that may limit the potential for predatory lending development in Canada

- Minority groups may not be as vulnerable in Canada as those in the U.S. – predatory lenders targeted minority groups in the U.S.. This was the fact that drew the ire of community groups and made predatory lending a high profile political issue. Canada does not have the high incidence of economically depressed ethnic ghettos excluded from mainstream borrowing that were the feeding ground for predatory lenders in the United States.
- The backlash against predatory lending in the U.S. may have a sobering influence in Canada – the backlash in the U.S. and the legislative response may serve as a warning to subprime lenders in Canada.
- Other alternative financial services may cut into the growth in equity based "distress" borrowing – among the responses to the survey was the suggestion that things were evolving differently in Canada, with those in financial distress being served by payday loans and debt consolidators. This may to some extent cut into the home-equity based predatory lending market.

Options that may support borrowers in Canada

Although no evidence of predatory mortgage lending practices in Canada was uncovered in this research, should such evidence present itself in the future, several options could be explored as considerations to enhance support to borrowers. These could include, among others:

- Educational material preparation – CMHC, in consultation with lenders could prepare an information pamphlet related to home equity borrowing and its risks and regulations. This would complement existing material available from CMHC and lenders relating to homeownership and mortgages. Lenders associations and provincial brokers associations could be asked to encourage members to distribute this pamphlet to those applying for home equity loans.
- Monitoring – the provinces and federal government could monitor mortgage disclosure regulations and other related regulations, and pool their data.The harmonization of the cost of credit disclosure rules which is underway facilitates this monitoring. This would enable regulators to keep track of whether predatory lending problems are developing.
- CMHC recognition of the importance of the subprime mortgage/home equity market – The subprime mortgage market can play an important role in providing access to funding for those with impaired credit ratings. Given the growing importance of this sector of the market, CMHC could further explore involving those lenders involved in this sector, collect and publish data separately on it, and work with subprime lenders to the mutually advantageous end of ensuring that the market works well and responsibly.

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